An Introduction to hedge dedesignation

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Hedge accounting uses derivative instruments to hedge risks inherent in some transactions to avoid volatility in earnings. Derivative instruments are the rights and obligations companies reflect in their financial statements as assets and liabilities (ASC 815-10-1 and CON 6). Companies measure their derivatives at fair value and report any fluctuations in their earnings. Hedge accounting offsets changes in the fair value of derivative instruments with changes in the fair value of hedge items in companies' earnings.

Hedge accounting is elective, and FASB permits companies to engage in hedging relationships if they meet all the qualifying criteria. If a hedge no longer meets its eligibility criteria, companies dedesignate (i.e., discontinue) the hedging relationship prospectively, either partially or completely (ASC 815-30-40-1). They can also establish a new hedging relationship that involves the same transaction and derivative instrument.

The dedesignation of the hedge relationship may occur due to any of the following:

- Change in eligibility or critical terms of hedge items (ASC 815-25-40 (all), cash flow hedges 815-30-40-1(all)).
- Change in eligibility or critical terms of hedge instruments (ASC 815-25-40 (all), cash flow hedges 815-30-40-1(all)).
- Change in the hedged risk (except for a cash flow hedge of a forecasted transaction in certain circumstances) (ASC 815-20-55-56).
- Change in hedge effectiveness on a retrospective and prospective basis (ASC 815-25-40-1(a), 815-30-40-1(all), 815-20-55-56).
- Elective dedesignation that an entity elects to discontinue the hedge relationship (ASC 815-25-40-1(c) and 815-30-40-1(c)).

Hedge dedesignation

There are three types of hedges, and companies may dedesignate (discontinue) them due to several reasons. The following section expounds on the ground that companies may dedesignate their hedges:

Cash flow hedge

A cash flow hedge is a hedge of the exposure to variability in the future cash flows of a recognized asset or liability, or a forecasted transaction, attributable to a particular risk. Companies dedesignate a cash flow hedge when they envision that forecasted transaction is no longer probable. There could be other factors that may result in dedesignation of a cash flow hedge; for example, companies had sold or extinguished assets and liabilities related to the hedge relationship, or

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SELF-STUDY DETAILS

Designed for: **CPAs with interests in hedge accounting**

Interest Area: **Accounting**

Learning objectives:

1. Understand an introduction of the dedesignation of hedges.

2. Understand the three different types of hedges and how they are applied.

3. Learn from examples to better understand the dedesignation of hedges.

Level: **All**

Prerequisite: **None**

companies do not have exposure to the variability of their earlier cash flow projection for any reason.

Companies reflect the changes in derivatives in the "accumulated other comprehensive income" (AOCI) that offset changes in the hedged item. At the end of the program, they offset the balances of the two accounts against each other with no impact on earnings. ASC 815-30-40 provides guidance for the prospective discontinuation of a cash flow hedge; for example, the hedge no longer meets all of the hedging criteria (e.g., probability of hedge occurrence and its effectiveness).

If a company discontinues the hedge and it is probable that the hedged forecasted transaction will not occur, it will account the subsequent changes in the fair value of derivative in earnings unless it is redesignated in a new qualifying hedging relationship (ASC 815-30-40-5). As a general rule, the entity reclasses the accumulated gains and losses in AOCI in earnings.

Fair value hedge

A fair value hedge is a hedge of the exposure to changes in the fair value of a recognized asset or liability, or a forecasted transaction, that is attributable to a particular risk. Companies offset changes in derivatives with changes in the hedge items' fair value. Thus, unanticipated changes in the fair value of the hedged items may require full or partial dedesignation of a hedge.

Companies discontinue their fair value hedges for several reasons; for example, they have sold or terminated the derivative instrument, or have removed the designation of the fair value hedge (ASC 815-25-40-1). Companies assess the compliance of the effectiveness criterion of their hedge relationship periodically (ASC 815-25-40-3); and if they conclude that their hedge is no longer effective, they recognize the changes in the fair value of the hedged items in earnings (ASC 815-25-40-4).

FASB permits use of the last-of-layer method that designate hedges of multiple layers in a closed portfolio of financial assets or one or more beneficial interests if companies have met certain criteria (ASC 815-20-25-12A). The last-of-layer method (designed with a focus on mortgage loans or mortgage-backed securities) permits an entity to designate the portion of a closed portfolio of prepayable financial assets as the hedged item in a fair value hedge.

If companies dedesignate a last-of-layer hedging relationship (fully or partially), they allocate the outstanding basis adjustment (or portion thereof) as of the discontinuation date to the remaining individual assets in the closed portfolio. Companies use a systematic and rational method rather than recognizing the whole amount in earnings (ASC 815-25-40-9).

Net investment hedge

A net investment hedge is a hedge of exposure to foreign currency risk of a net investment in a foreign corporation. Thus, for example, changes in ownership or the net investment balance may require the dedesignation of the hedge. As long as the hedging relationship in a net investment hedge is highly effective, companies record the change in the fair value of the derivative attributable to the changes in the spot rate in the CTA section of OCI.

Similar to cash flow hedges, if companies dedesignate a hedge relationship, they will account for the subsequent changes in the fair value of the derivative in earnings. Generally, companies reclassify the accumulated gains and losses in AOCI to earnings after dedesignation.

TABLE A

Year Ending Dec. 31, ____	IRSW Fixed Leg	SOFR Variable Leg	SOFR Variable Leg Plus 1%	Fair Value Adjustment of IRSW (1)
2023	7%	6%	7%	0 (2)
2024	7%	5%	6%	($1,834) (3)
2025	7%	8.5%	9.5%	$4,037 (4)
Dec. 31, 2025	7%	-	-	($2,203) (5)

1. In this example, the article has taken only the interest rate as a factor for fair value determination. There are other factors that may involve (e.g., credit worthiness of the company, etc.).
2. Contract's fixed rate and LIBOR plus rate are both equal to 7%; therefore, fair value adjustment is nil.
3. [$100,000 x (1.06) -2] + [$7,000 x (1.06) -1] + [$7.000 x (1.06) -2] = $101,834
   $100,000 - $101,834 = ($1,834)
4. [$100,000 x (1.095) -1] + [$7,000 x (1.095) -1] = $97,797
   $101,834 - $97,797 = $4,037
5. [$100,000 x [(1.08) -0] = $100,000
   $100,000 – $97,797 = $2,203

2023 Designated Fair Value Hedge

Cash $100,000
Loan $100,000
Initiation of the loan

Int. Exp. $7,000
Cash $7,000
Annual interest on the loan

Swap $1,834
Loan $1,834
Increase in the fair value of the loan due to lower interest rate

2023 Dedesignated Fair Value Hedge

Cash $100,000
Loan $100,000
Initiation of the loan

Int. Exp. $7,000
Cash $7,000
Annual interest on the loan

Swap $1,834
Loan $1,834
Increase in the fair value of the loan due to lower interest rate

2024 Designated Fair Value Hedge

Int. Exp. $7,000
Cash. $7,000
Annual interest on the loan

Cash $1,000
Int. Exp. $1,000
Difference between receive 7% fixed rate and pay 6% variable rate

Loan $4,037
Swap $4,037
Decrease in the fair value of the loan due to higher interest rate

2024 Dedesignated Fair Value Hedge

Int. Exp. $7,000
Cash. $7,000
Annual interest on the loan

Earnings $1,834
Swap $1,834
Writing off the adjusted fair value of hedge in 2023 to earnings due to designation.

Loan $4,037
Swap $4,037
Decrease in the fair value of the loan due to higher interest rate

2025 Designated Fair Value Hedge

Int. Exp. $7,000
Cash. $7,000
Annual interest on the loan

Loan $100,000
Cash $100,000
Paying off of the loan

Int. Exp. $2,500
Cash $2,500
Difference between receive 7% fixed rate and pay 9.5% variable rate

Loan $2,203
Swap $2,203
Termination of the hedge

2025 Dedesignated Fair Value Hedge

Int. Exp. $7,000
Cash. $7,000
Annual interest on the loan

Loan $100,000
Cash $100,000
Paying off of the loan

Loan $2,203
Earnings $2,203
Termination of the hedge

Illustration

The preceding (Table A) is an example of accounting for an interest rate swap (IRSW) fair value hedge. Entity A has a fixed rate obligation and enters into a "receive-fixed, pay-floating" IRSW arrangement, with the variable leg of the swap set on Secured Overnight Financing Rate (SOFR) to avoid volatility in its earnings as a result of fluctuation in the fair value of its obligation due to interest rate changes.

On Jan. 2, 2023, Entity A issued a $100,000, non-callable, 7% fixed-rate note at par value. The note matures on Dec. 31, 2025, with annual interest payments due in the arrear on December 31 of each year until maturity. On Jan. 2, 2023, Entity A enters into an IRSW arrangement for a $100,000 notional amount. The swap receives interest at a fixed rate of 7% for its fixed leg throughout the term of the swap and pays interest at a variable rate equal to SOFR plus 1% for the variable leg of the swap throughout its term.

The variable rate of the interest rate swap resets each year on December 31

TABLE B

		Designated Fair Value Hedge	Dedesignated Fair Value Hedge
2023	Hedge remains designated through 2023	$0	$0
2024	Dedesignation occurs on Jan. 2, 2024	$0	$1,834
2024	Hedge is no longer designated	$0	($4,037)
2025	Hedge is no longer designated	$0	$2,203
Total	As of Dec. 31, 2025	$0	$0

TABLE C

		Designated Fair Value Hedge	Dedesignated Fair Value Hedge
2023	Annual interest on loan	$7,000	$7,000
2024	Annual interest on loan	$7,000	$7,000
2024	Diff. between fixed and variable rates	($1,000)	$0
2025	Annual interest on loan	$7,000	$7,000
2025	Diff. between fixed and variable rates	$2,500	$0
Total	As of Dec. 31, 2025	$22,500	$21,000

for the payment due in the following year. The present value of the debt discounted at the hedge inception benchmark rate is equal to the par value of the debt.

On Jan. 2, 2024, Entity A dedesignates the hedge relationship due to the termination of the derivative instrument. The following journal entries reflect two scenarios: the left side of the table are journal entries as if the hedge relationship would have continued, and the right side are journal entries as if the hedge relationship were dedesignated. The 2023 journal entries remain the same under both alternatives since the hedge relationship was in effect in this period.

The following schedule (Table B) reflects the impact of the fair value hedge on earnings before and after the designation:

The above table reflects that the dedesignation of the hedge initiates volatility in earnings; however, this volatility does not impact the total result of the fair value fluctuation on Dec. 31, 2025.

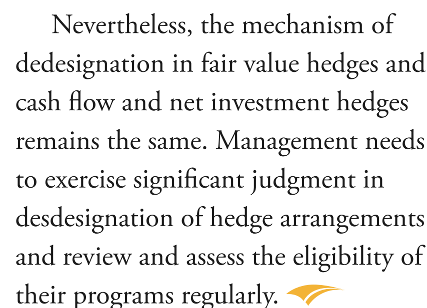
The following table (Table C) reflects the interest expenses that the company has incurred before and after the designation:

The above table reflects Entity A's total interests under the designated and dedesignated alternatives. In this example, Entity A has benefited by incurring less interest under the dedesignated scenario; however, the purpose of a hedge is not to save or reduce the amount of interest but to control the volatility in earnings.

Conclusion

This article was an introduction to the dedesignation of hedges. The example reflected the dedesignation of a hypothetical fair value hedge relationship. If the company in this example had a variable interest loan and arranged for a "receive-floating, pay-fixed" IRSW hedge, it had to initiate a cash flow hedge instead of a fair value hedge. FASB requires companies to reflect fluctuations in the cash flow hedge in OCI—similarly, net investment hedges reflect these fluctuations in the "cumulative translation adjustment" (CTA) section of the OCI.

Nevertheless, the mechanism of dedesignation in fair value hedges and cash flow and net investment hedges remains the same. Management needs to exercise significant judgment in desdesignation of hedge arrangements and review and assess the eligibility of their programs regularly.



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1. Hedge accounting allows an entity to hedge risks inherent in some transactions _______________ by using derivative instruments.

- (A) To increase earnings
- (B) To pay less taxes
- (C) To avoid volatility in earnings
- (D) All the above.

2. _______________, companies dedesignate (i.e., discontinue) the hedging relationship prospectively, either partially or completely.

- (A) If a hedge no longer meets its eligibility criteria
- (B) If the Federal Reserve raises the benchmark interest rate again
- (C) If the stock market crashes
- (D) If the stock market drops modestly

3. There is/are ________ type(s) of hedge(s).

- (A) Four
- (B) Three
- (C) Two
- (D) One

4. A fair value hedge is a hedge of the exposure:

- (A) To variability in the future cash flows of a recognized asset or liability, or a forecasted transaction.
- (B) To foreign currency risk of a net investment in a foreign corporation.
- (C) Both A and B.
- (D) To changes in the fair value of a recognized asset or liability, or a forecasted transaction, that is attributable to a particular risk.

5. The article argues that the dedesignation of the hedge:

- (A) Initiates volatility in earnings.
- (B) However, this volatility does not impact the total result of the fair value fluctuation.
- (C) Both A and B.
- (D) Neither A or B.

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